ECONOMIC OUTLOOK

FIGURE ECON–1

Key Economic Indicators

(Annual Percent Change, except for New Housing)

		Forecast	
	2003	**2004**	**2005**
U.S. Gross Domestic Product, adjusted for inflation	2.9 %	4.2 %	3.6 %
California Nonfarm Employment	-0.2 %	1.1 %	2.1 %
California Personal Income	3.8 %	5.6 %	5.9 %
California Consumer Price Index	2.4 %	1.9 %	2.7 %
California New Housing Units	194,000	192,000	198,000

The national and California economies strengthened in the second half of 2003. Increased business investment and job growth—the two missing pieces of a sustainable, stronger economic recovery—appeared to be in place as year-end neared. Improved labor markets and stronger output growth are expected for both economies in 2004 and 2005.

The Nation

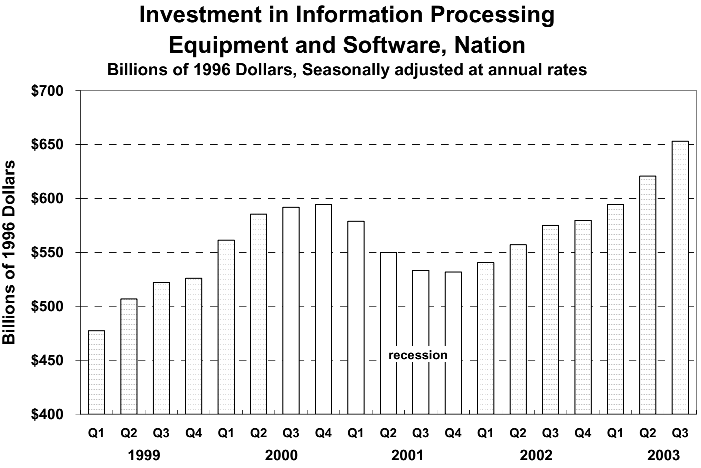
- National economic output expanded at its quickest rate in nearly 20 years in the third quarter. Even better, the gain was broad-based across spending categories. Tax refunds and tax rate cuts spurred consumers to boost their spending. Businesses invested considerably more in equipment and software. Residential construction posted a big gain. Even net exports added to the economy's growth.

- Gross private domestic investment grew by over 18 percent at a seasonally adjusted, annual rate in the third quarter. Within this category, nonresidential fixed investment expanded by 14 percent and residential investment, by 23 percent. Spending on information processing equipment and software surged by 23 percent. All of this was particularly encouraging because the primary cause of the economy's sluggishness earlier in the recovery was weak business investment.

- Growth should accelerate to 4.2 percent in 2004. After cooling in the fourth quarter of 2003, consumer spending will pick up in 2004, fueled by bigger employment gains and larger than normal tax refunds. The stronger economic climate and the temporary tax incentives for investment in equipment and some software introduced in the May 2003 tax package will boost investment spending further in 2004. Nonfarm payroll employment will grow by about 150,000 jobs per month in the first two quarters of 2004 before accelerating to about 250,000 per month for the remainder of the year. This is somewhat slow by historical standards.

- Tight energy supplies pose a risk to the outlook. Worldwide oil production is currently close to capacity, and the gap between supply and demand in the North American natural gas market is very thin. A disturbance to oil output or unusually cold weather in North America this winter could cause energy prices to soar just as world growth is set to accelerate in 2004.

FIGURE ECON–2



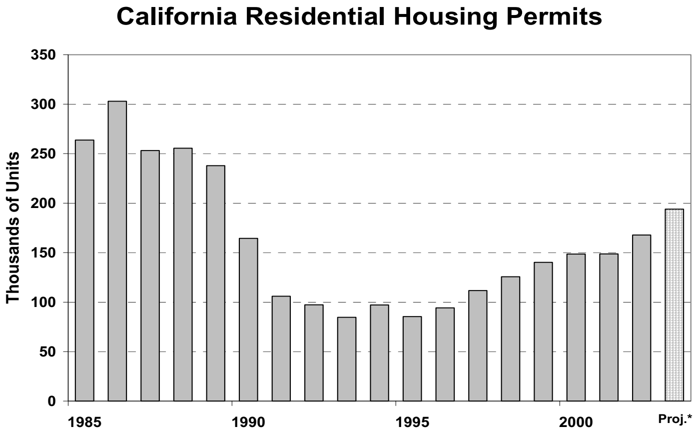
California

- The recovery of the California economy broadened and strengthened in 2003. California personal income increased for the sixth consecutive quarter in the second quarter of 2003. Also encouraging, exports of made-in-California merchandise began to increase again in the third quarter after falling for nearly three years, and taxable sales posted a fifth consecutive year-over-year gain. In addition, manufacturing activity expanded in the third quarter in the Inland Empire and Orange County according to local surveys of purchasing managers. But California labor markets were not as strong as those in the rest of the nation, on average, near year-end.

- California's tourism industry continued to improve while remaining below pre-September 11 levels. The "drive-to" market did best, convention business improved, but business travel remained weak. Residential construction and real estate remained strong. Through October, home permits were on a pace to hit 194,000 units for the year, about a 16 percent gain over 2002 and the highest level since 1989. In the first ten months of 2003, sales of existing, detached single-family homes were up 3.5 percent from a year earlier, and the percentage increase in the median price of these homes was in the mid-teens. Commercial real estate building and markets did not fare as well; building was down and markets were just slightly improved.

- The outlook for the California economy is for moderate growth in 2004 and even better growth in 2005. Unemployment will likely remain above 6 percent throughout the period. Personal income will grow by about 5.6 percent in 2004 and almost 6 percent in 2005—good, but not as quickly as in past recoveries. Low interest rates and a considerable amount of federal fiscal stimulus will boost the state economy in 2004. Cuts in expenditures to reduce the state government budget deficit will be a drag on the state economy, however.
- Consumers are the linchpins of the outlook. They have to continue to be optimistic that stronger labor markets lie just ahead.

FIGURE ECON–3



*The number of permits shown for 2003 is a projection based on the rate for the first ten months of the year.